

The G20 “Common Framework for Debt Treatments beyond the DSSI”: Is it bound to fail?

Briefing • October 2020

By Daniel Munevar

1. The likely structure of the framework

The G20 recently announced the agreement in principle of a “Common Framework for Debt Treatments beyond the **Debt Service Suspension Initiative** (DSSI)”. The framework aims to address the problem of **unsustainable debts** faced by many countries in the aftermath of the Covid-19 pandemic. The agreement, which includes all members of the G20 and the Paris Club, still requires domestic approval by all the participants. The adoption and details of the framework are set to be published at an extraordinary meeting of G20 Finance Ministers and Central Bank Governors ahead of the G20 Summit on 21-22 November.

The lack of transparency around the framework is troubling for at least two reasons. First, the potential amounts of debt relief involved dwarf the scale of the G20 DSSI. After its recent six-month extension, the DSSI is projected to allow 46 participant countries to suspend payments for a total of US\$11.7 billion. In contrast, the public external debt stock for countries eligible for DSSI countries stood at **US\$477 billion** in 2018. Even a partial write-off of these debts would have substantial financial repercussions.

Second, for a large number of developing countries, the scope of the debt treatments agreed by the G20 represent the difference between achieving a sustainable post Covid-19 recovery or a lost decade for development. The absence of a seat at the table, or to be more precise, the absence of a Zoom code for G20 Finance Ministers’ meetings keeps them in the dark regarding decisions that will define their future.

While the details of the Common Framework remain hidden from the public, there are pieces of information that allow us to assemble an outline of what the G20 agreement could actually deliver and its implications for developing countries.

Putting together the puzzle pieces

The G20 approach to debt vulnerabilities in the context of the pandemic has been framed by the **six principles** of the **Paris Club**. These include solidarity, consensus and information sharing amongst Club **members**; the requirement of an International Monetary Fund (IMF) programme; and last but not least, comparability of treatment for non-Paris Club commercial and bilateral creditors. These elements, including the increasingly controversial participation on a voluntary basis by **private** and **multilateral** creditors, are the foundation of the DSSI.

Furthermore, the DSSI is simply a modified version of the Paris Club’s **classic debt treatment**. This mechanism was established at the time of the creation of the Club in **1956**. It allows debtor countries to reschedule their debt payments using an interest rate and repayment period to be defined on a case-by-case basis by the Club. In contrast, the DSSI set a common benchmark for a temporary debt payment suspension for all participant countries. Suspension is designed to be **Net Present Value (NPV) neutral** and the repayment window includes a one-year grace period to be followed by a five year payment period.

Given the complex nature of the negotiations to go beyond DSSI, it is unlikely that the G20 will deviate substantially from this approach in the design of the Common Framework. This conservative approach to debt crisis resolution is emphasised by a recent **IMF policy paper**. The document sets out the official position of the organisation regarding the required changes to the international architecture on debt resolution. While the IMF acknowledges the daunting challenges posed by the pandemic, it abstains from suggesting substantial changes to the current framework. Instead, the IMF supports the establishment of a common approach to official debt relief, including the Paris Club members and others, alongside improvements in debt transparency and contractual arrangements.

Thus, if the scope for innovation in the Common Framework is negligible, its structure is likely to resemble an established Paris Club mechanism.

The Common Framework: An Evian+ approach?

The **Evian approach** is the most recent debt relief mechanism created by the Paris Club. Established in 2003, this approach is designed to address the debt vulnerabilities of middle-income countries. Debt treatments are granted on the basis of Debt Sustainability Assessments (DSAs) conducted independently by the IMF and Paris Club members. Countries that are identified as experiencing liquidity problems are provided with a debt treatment under the **traditional terms** of the Paris Club. Countries that are experiencing solvency problems are granted a comprehensive debt treatment, including extensive debt write-offs, on a case-by-case basis.

Debt relief under the Evian approach follows a three-stage process. The first stage involves an official request by the debtor country alongside the establishment of an IMF programme and a rescheduling of debt payments for a period of one to three years. A second stage requires a second IMF arrangement and may involve the provision of an initial amount of debt relief. The third and final stage requires the successful completion of the IMF programme and a successful track record of compliance with the Paris Club over time. Only if these criteria are met is the country eligible to receive full debt relief under the terms of the approach.

The structure of the Evian approach fits perfectly with the evolving response of the G20. The Common Framework seems destined to share the most important principles and characteristics of the Evian approach. This **will include** the principle of comparability of treatment. Under the Evian treatment, participant countries are **contractually required** to seek debt relief from non-Paris Club commercial and bilateral creditors on comparable terms to those granted by the Paris Club members. Factors for assessing comparability include changes in nominal debt service, NPV and duration of the restructured debt. Participation by private creditors in debt relief efforts under the Common Framework would probably take place under this clause.

The sequencing of the Evian approach would also match the timing of the Common Framework. Participant countries in the DSSI can be considered to be in the first stage of the Evian approach. In the context of the pandemic, the second stage of the approach would map on to the **transition** of a number of countries from IMF emergency financing under the Rapid Credit Facility (RCF) and Rapid Financing Instrument (RFI) into standard IMF programmes in the near future.

G20 approach is bound to fail

Despite these similarities, it is possible to expect important differences. First, the Common Framework will probably apply to all DSSI countries, regardless of income levels. Given the **US-China** differences, it is rather unlikely that the G20 will agree at this stage to provide special treatment to low-income countries on standardised terms similar to those of the Heavily Indebted Poor Countries (HIPC) initiative. In that case, the Paris Club granted, under the **Cologne terms**, a cancellation of up to 90 per cent of non-Official Development Assistance (ODA) credits. Nothing as substantial seems to be under discussion at this stage.

Second, the IMF and its DSA could play a more prominent role in the Common Framework. Following an **IMF proposal for the DSSI**, and subject to individual country applications, Common Framework eligibility could be limited to countries identified by the IMF as being at high risk or in debt distress or their debts may be considered unsustainable.

Under this assumption, a total of 25 countries covered by the IMF Low-Income Country Debt Sustainability Framework (LIC DSF) would be eligible for the Common Framework: Afghanistan, Cabo Verde, Cameroon, Central African Republic, Chad, Djibouti, Ethiopia, Gambia, Ghana, Grenada, Haiti, Kenya, Liberia, Malawi, Maldives, Mauritania, Mozambique, Papua New Guinea, Samoa, Sao Tome and Principe, Sierra Leone, Somalia, St. Vincent and the Grenadines, Tajikistan and Togo. Several middle-income countries whose debts were classified as sustainable to facilitate their access to IMF emergency financing, but have a high degree of vulnerability, are likely to become eligible as well, pending a revision of their risk rating by the IMF. This group would include countries such as Angola, Nigeria and Pakistan.

The G20 approach, which seeks to adjust the problem to the available tools rather than the other way around, is **bound to fail**, as has been shown by the experience of the DSSI. G20 officials are not going to have to deal with the consequences of the decisions they are adopting in virtual meeting rooms. Instead, millions of people in developing countries will have to live with the effects of their failure to respond to a crisis of historic proportions.

2. A Paris Club-based approach is unlikely to succeed

Since the start of the coronavirus pandemic, the G20 has settled for **repurposing** established Paris Club mechanisms to tackle the problem of developing countries' unsustainable debts. Going forward, a Paris Club-based approach to address debt vulnerabilities by the G20, in the form of the "Common Framework for Debt Treatments beyond the DSSI", is unlikely to succeed. The predicted failure of the G20 response will condemn a large number of developing countries to a lost decade. The explanation behind this dismal prediction can be found in the complex interactions between creditors, as we will see below.

Who will bear the costs of the G20 Common Framework?

The core challenge faced by any process of debt resolution is the equitable distribution of losses arising from insolvency. On the one hand, between debtors and creditors. On the other hand, within the creditor base. In the case of the former, a historical and structural power imbalance has traditionally shifted the costs from creditors to sovereign debtors. This is exemplified by the **too little, too late** ongoing problem of debt restructuring. This pattern is set to continue. The G20 is a creditor forum where measures adopted are a result of the complex interaction of competing geopolitical interests. Solving the actual problems of developing countries isn't particularly high on the agenda in the aftermath of the pandemic, as symbolised by the **failure of the DSSI**.

By extension, the focus of the G20 discussions is on the latter element: the allocation of losses between creditors. Over the last decade, the proliferation of debt instruments and the diversification of the creditor base has **increased the complexity** of these processes. To address this problem, the International Monetary Fund (IMF) has suggested two mechanisms. First, an agreement on a **common approach** to debt restructuring between the Paris Club and others. Specifically, China. Second, the use of **Debt Sustainability Assessment (DSA) risk ratings** to limit eligibility for debt relief.

China is likely to subvert both mechanisms. In the first case, it is unlikely that China will agree, and most importantly, comply with a framework for debt relief under the Paris Club. The Club is a **diplomatic** tool that reflects the political priorities of its members through consensus. There is **no natural room**, nor incentive, for China to be a part of this. Efforts to force China into this space can only lead to acronymous confrontations across country-by-country debt relief negotiations. This dynamic could be exacerbated by the second mechanism. An explicit link between the IMF DSA and eligibility for the Common Framework would force official and private creditors from China to bear the brunt of the costs of debt relief (Table 1).

Table 1: Public Debt Composition for Countries Assessed to be in Debt Distress or at High-risk of Debt Distress (Average share in per cent, 2018)

	Multi-laterals	Paris Club	Non-Paris Club	Private
In debt distress	35	14	33	18
High risk of debt distress	48	4	32	16

Source: Eurodad (2020)

Tangled governance: Delaying the inevitable

History shows that creditors will rely on any mechanism available to **delay the recognition** of insolvency. This allows them to shift a substantial share of the losses towards the creditors. Examples include the **US in the 1980s debt crisis** and, more recently, **Germany and France** in the Greek debt crisis. By these standards, opposition to debt relief in the aftermath of Covid-19, by both China and private creditors, is to be expected. Both groups of creditors stand to benefit from complicated and opaque arrangements. **Regime complexity** and conflict enable key creditors to shape and delay the outcomes of debt relief. Thus, in contrast to transparent and standardised treatments, case-by-case negotiations are a perfect setting for undermining effective debt relief under the Common Framework.

If the Common Framework ends up being framed as an **Evian+ approach**, this will allow China and private creditors to exploit two related mechanisms to delay the inevitable: non-transparency of public debt and comparability of treatment.

Non-transparency of public debt

Despite being a matter of public interest, available information on public debt is **hard to find and is often incoherent**. This makes it difficult to gain a comprehensive overview of creditor composition. Without it, ensuring an equitable distribution of losses amongst creditors becomes an impossible task. This dynamic creates incentives for creditors to remain hidden. This allows them to avoid participation in debt relief efforts and to shift the losses on to the rest of the creditor base.

China and private creditors are both at fault of obscuring public debt information. Most of the focus on the debate and demands for transparency have been placed on China. Extensive use of collateralised loans and project financing under different arrangements have made it a difficult endeavour to **assess** the amount of debt owed to China. Private creditors are no better.

Identifying bondholders and providers of credits is equally difficult. Use of **structured repo agreements** facilitated by investment banks has added a layer of complexity to debt restructuring processes. A consent solicitation to materially alter the terms of the bond, the step that precedes an official default, remains the only reliable mechanism to identify commercial creditors on an accurate basis.

The DSSI aimed to address this problem, but with little success. In the latest update on the implementation of the initiative, the IMF acknowledged that creditor disclosure on terms and amounts lent remains **limited**. This is unlikely to change with the implementation of the Common Framework. As can be seen in recent developments in **Angola** and **Zambia**, non-transparency in public debt lends arguments to both groups of creditors to lengthen negotiations and delay the implementation of debt relief.

Comparability of treatment and terms of debt restructuring

An even bigger obstacle for a swift implementation of the Common Framework is related to the terms of debt restructuring. Under the Evian approach, debt treatments are considered on a case-by-case basis. Countries with similar debt burdens may end up with different amounts of debt relief depending on the **economic and political interests** of creditors. From a technical perspective, it is difficult for the Paris Club to **establish comparability** between creditors that choose to reschedule flows and those that restructure their stocks of debt.

A central problem for the Common Framework will be the interaction between restructuring terms offered by China and private creditors. A **review** of debt restructuring terms involving credits from China shows a mixed picture. Debt write-offs have been applied only to official non-interest bearing loans. Restructuring of credits on commercial terms are negotiated on a loan-by-loan basis. Rescheduling is the most common form of treatment, while write-offs are a rare exception.

The potential for conflict is clear. It will be extremely difficult for the Paris Club to enforce comparability of treatment. Private creditors will refuse to agree to debt write-offs unless commercial creditors from China participate on similar terms. Under the principle of comparability they will have the right to do so. This rationale also applies the other way round.

This dynamic creates a series of problems. Even if a large number of private creditors agree to participate in debt restructuring, the potential for vulture funds – or any investment fund – to block agreements remains high. A **review** of the contractual terms for 52 series of bond issues of 16 low-income countries shows that at least 29 per cent of the bonds lack the last generation of **Collective Action Clauses (CACs)**. This opens the door for vulture funds to block relief efforts on specific bond series, even if an agreement with China commercial creditors is reached by a majority of bondholders. Furthermore, if the Paris Club only manages to reach agreement – internally and with the rest of creditors – on debt reschedulings, the effective amount of debt relief that can be granted may be well below what is required to re-establish debt sustainability. "**Steep and prolonged fiscal consolidation**" would be the inevitable complement of insufficient debt relief. Austerity measures to free up resources to meet creditor claims would be implemented through the prerequisite IMF programmes that will likely be the foundation of the Common Framework.

Comparability between creditors... and what happens to the debtors?

An identified **asymmetry** of Paris Club processes is the emphasis of achieving solidarity and comparability between creditors while showing a complete disregard for applying the same criteria to debtors. By using the Paris Club modus operandi in drafting its response to the crisis, the G20 has replicated this flawed and outdated approach. Developing countries are being asked to deal with unprecedented economic, health and social crises while being crushed by competing groups of creditors.

However, there is still time to change course before it is too late. Even the IMF is aware that the Common Framework might end up in failure. In its recent assessment of the international architecture of sovereign debt, the IMF warns that an approach based on official creditor coordination and improvements in contractual arrangements "might not be adequate" to avoid a protracted debt crisis. The flaws of the current non-system of debt restructuring call for a complete overhaul of the international architecture. Now more than ever multilateral discussions should move to promote a systematic and timely approach to orderly, fair, transparent and durable sovereign debt crisis resolution. This involves establishing a **multilateral debt work out mechanism**. Failure to do so risks repeating the costly mistakes of the past. We cannot afford to let the prospects for development of an entire generation in the Global South be sacrificed to creditor interests as it happened in the 1980s.



Contact

Eurodad
Rue d'Edimbourg 18-26
1050 Brussels Belgium
+32 (0) 2 894 4640
assistant@eurodad.org
www.eurodad.org

This briefing has been produced with the financial assistance of the European Union and Bread for the World. The contents of this publication are the sole responsibility of Eurodad and the authors of this report and can in no way be taken to reflect the views of the funders.



Brot
für die Welt